Currencies: Should There Be Five or One Hundred and Five?

by Ricardo Hausmann

It was not supposed to turn out this way. The collapse of communism in the former Soviet Union and the abandonment of the interventionist and populist state in Latin America more than a decade ago were supposed to usher in a period of unparalleled prosperity. The invisible and efficient hand of the market, now made more powerful through globalization, would succeed where the incompetent and often bloody hand of government had failed. But more than a decade after the annunciation of this "end of history," country after country among the new emerging-market economies has fallen into financial crises, the likes of which have not been seen since the Great Depression of the 1930s or the Latin American debt crisis of the 1980s. Economic turmoil has afflicted not only those countries with poor policy records, but also those held out as models (such as Mexico before 1994 and the East Asian tigers until 1997), destroying livelihoods, crushing hopes, and increasing human suffering.

This cataclysm also shattered the consensus among bankers, policymakers, academics, and ideologues about appropriate economic policy in emerging markets. As economic professionals now return to the drawing board, one question is generating particularly fierce debate: Should emerging-market countries allow their currencies to float freely, or should they abandon them altogether in favor of strong international or supranational currencies such as the U.S. dollar or the euro? Interestingly, the debate has quickly become polarized: Both sides seem to accept that there can be no middle ground, no halfway arrangement between allowing a currency to float freely and bolting it down completely.

Moral Hazard Versus Original Sin

The debate between "floaters" and "dollarizers" reflects the broader debate over the precise causes of the recent financial turmoil. Two opposing explanations have emerged: a dominant view based on what economists call "moral hazard" and an alternative theory based on what might be called "original sin."

Just about anyone who has read about the financial crises in Asia, Latin America, and Russia has become familiar with the concept of moral hazard—the increase in recklessness that takes place when people are somehow protected against the consequences of their risky behavior. For example, car insurance may make people drive faster or park their cars in neighborhoods where the chances of vandalism or theft are higher. By the same logic, the readiness of governments and international institutions to provide bailouts in times of emerging-market (and other) financial crises may make investors less vigilant about weighing all the risks involved.

The view that moral hazard is to blame for the recent financial turmoil has inspired an ambitious roster of reforms for the international financial architecture. This agenda includes moves to upgrade the financial supervision and regulation of individual countries, eliminate or reduce the provision of international bailouts by the International Monetary Fund (imf), and develop "bailing in" procedures to ensure that the investors themselves play a role in resolving future crises. [See: "Think Again: International Financial System," on page TK.]

But in addition to bailouts, there is another element of moral hazard that is often overlooked in the headlines: exchange rate regimes. Fixed exchange rates can serve as an implicit guarantee that a government will protect the value of its currency, and thus, keep investments safe as well. Consequently, some economists advocate the adoption of floating exchange rates so that investors face the real risks of speculating in emerging- market currencies.

But is moral hazard really the core of the problem? After all, although car insurance may lead to some degree of increased recklessness, we still seem to believe that a world that offers such insurance is better than one that does not (otherwise the protection would not exist). In addition, the moral-hazard view of financial crises must answer the *Jerry Maguire* "show me the money" critique. Moral hazard implies there is too much capital flooding the international financial system; it would explain excessive rather than surprisingly low international capital flows. Yet, in spite of the Internet and electronic wire transfers, there is proportionally less capital flowing across borders today than there was a century ago. In short, if moral hazard is so important, then "show me the money!"

The alternative theory, "original sin," seeks to explain why many emerging markets are volatile and prone to crisis by focusing on three characteristics that such countries often share: good economic prospects, a certain degree of openness to international capital flows, and a national currency that cannot be used by local firms or the government to borrow abroad, and cannot be used, even at home, for long-term borrowing—a weakness, or "sin," shared by the currencies of almost all emerging-market economies.

If a country is economically promising and reasonably open, then people will want to invest. But if its currency cannot be used for either foreign or long-term borrowing, would-be investors must choose between borrowing in a foreign currency such as dollars or borrowing short-term. If a company borrows in dollars to finance a project that generates pesos, a subsequent devaluation of the peso could lead to bankruptcy. If instead the company undertakes a longer-term project and finances it with short-term loans, it will go bust if liquidity dries up and it cannot get the loans renewed. In other words, investments will suffer either from a currency mismatch, because projects that generate local currency are financed with dollar loans, or a maturity mismatch, because longer-term investments have been financed with short-term loans.

This scenario is a recipe for financial fragility. Such systems will be extremely vulnerable to sudden declines in the amount of liquidity in the banking system and to sudden depreciations of the currency. In fact, as the domestic currency starts to decline, companies fearful of further depreciation will attempt to buy foreign currency in order to cover their exposures. This decision will only make matters worse by causing the domestic currency to depreciate even further—a dynamic that can take place even in a floating-rate country, as was the case of Indonesia at the time of its final collapse. For its part, the government will seek to defend the currency by using its international reserves. But using those reserves will dry up the amount of money in the domestic banking system, and as liquidity declines, banks will be forced to call in their loans, precipitating a banking crisis caused by the maturity mismatches. So the two mismatches interact. In fact, such a system is subject to self-fulfilling crises, as in a bank run: If people fear that others may take their money out, they will want to be the first to the door.

At the international level, the various moves afoot to strengthen the financial architecture should go some way toward limiting volatility. At the national level, however, the competing theories of moral hazard and original sin suggest two very different sets of options for countries with respect to monetary systems. The moral-hazard explanation suggests that letting exchange rates float would limit volatility by making investors bear the full risk of moving capital in and out of a country. But if the problem is rooted in original sin rather than moral hazard, allowing the currency to float will not have much of an impact: As long as the national currency, whether fixed or floating, is one that cannot be used for foreign or long-term borrowing, financial stability will remain elusive.

The False Promise of Floating Rates

One idea embraced by almost all economists is that the choice of a monetary system involves a trilemma: There is an inherent trade off among choosing the level of the exchange rate, choosing the level of the interest rate, and allowing capital to move in and out of a country freely. Governments can control two out of three, but not all three. If a government decides to fix the exchange rate and allow capital to move freely, it must accept whatever interest rate the market demands. If instead it decides to control the interest rate and allow capital to move freely, it must let the exchange rate float. Finally, if it wants to control both the exchange rate and the interest rate, then it must impose effective capital controls.

The terms of the trilemma have shifted over time, with floating exchange systems a relatively recent phenomenon. Before the **TK** century, most governments maintained their currencies pegged in value to some underlying asset, typically gold or silver. During periods of war, countries often abandoned convertibility to gold or silver but returned to it as quickly as they could, as for example after the Civil War in the United States or after World War I in Europe.

When the Bretton Woods Conference was convened in 1944 to plan the monetary system for the postwar period, the signatory countries opted for a system of fixed or “pegged” exchange rates with the U.S. dollar at its core. In part, the choice of a fixed system was in response to the ruinous competitive currency devaluations of the 1930s. The imf was created in order to assist countries with the financing necessary to ease payments crises and sustain the pegs. These were times when capital could not move freely across borders, so countries could control both exchange rates and interest rates. Under the influence of economist John Maynard Keynes, monetary policy was thought of as an instrument to dampen cyclical booms and recessions. It was monetary policy as speed control: Interest rates were increased to slow down a boom and lowered to prevent a recession.

This fixed system eventually collapsed in 1971, in part because the United States, unable to garner domestic political support to pay for the unpopular Vietnam War, ended up pursuing lax fiscal and monetary policies. But the system also collapsed because the increasingly free movement of capital meant that the terms of the trilemma had shifted: Governments now had to choose between controlling the exchange rate or the interest rate, as they could no longer control both. The Bretton Woods system was replaced by a regime in which the world's major currencies floated against one another. It was thought that this plan would allow countries to gain control over interest rates and avoid importing U.S. inflation through rising import prices. Instead, they could compensate for rising dollar prices by strengthening their domestic currency and thus, keep inflation in check at home.

The floating system was also supposed to eliminate currency misalignments. Exchange rates would move in an orderly and automatic fashion to compensate for differences in inflation, keeping relative competitiveness stable. The system would permit countries to absorb shocks more easily through movements of the exchange rate. It would allow countries to choose their own mix of inflation and unemployment based on their sovereign preferences. With hindsight, in the words of Harvard [ck] economist Richard Cooper, these views appear "charmingly naïve."

Instead of smoothness and orderliness, the system of floating rates among the major countries has produced large and unpredictable exchange rate movements. The perception of severe currency misalignments led the Group of Seven (G-7) to attempt policy coordination in the mid-1980s, as the strong dollar had produced a huge U.S. trade deficit and enormous protectionist pressures. Yet, despite almost 15 years of G-7 coordination, the volatility of exchange rates remains enormous. For example, over the past few years, the yen-dollar rate has moved from 80 to 140 yen to the dollar, almost a 100 percent margin.

Emerging markets never opted voluntarily for floating regimes. Most of their currencies were fixed to the dollar during the Bretton Woods period and only came off the pegs in the context of various economic crises. Many of these countries then opted for regimes that had limited flexibility of different sorts, such as exchange rate bands and "crawling pegs." Only recently, with the collapse of such schemes in East Asia and Latin America, have purely floating regimes become more widely used. Given that they are entering uncharted territory, it is fair to ask what emerging-market countries can really expect from a world of floating exchange rates.

The answers are not encouraging. Recent experience in Latin America suggests that the new popularity of floating rates may reflect yet another form of charming naïveté. Floating regimes have not delivered much in the areas they were supposed to help: They have failed to provide more exchange rate autonomy, they have not facilitated more stabilizing monetary policies, and they have not led to an increased ability to absorb shocks.

Domestic interest rates in fact seem more sensitive to foreign rates under floating rather than fixed regimes, which implies less, not more, monetary independence. When the cost of foreign borrowing goes up by 1 percent, for example, domestic interest rates go up by 1.4 percent under Argentina's fixed rate currency board and by 5.9 percent under Mexico's floating regime. Floating has also undermined monetary policy as an effective tool to stabilize the economy. For instance, domestic interest rates tend to go up instead of down during a recession (even more drastically than they would under a fixed regime). And floating in Latin America has increased the volatility of domestic interest rates, making banking a riskier industry.

Finally, the experiences of Chile, Mexico, Peru, or Venezuela—after the East Asian crisis of 1997 and the collapse in commodity prices in 1998—suggest that emerging-market countries with formal floating regimes do not allow their currencies to move much even after huge external shocks. Instead, they react by raising interest rates dramatically. Floating rates in Latin America have therefore failed to deliver on the speed control and shock absorption qualities they promised.

On top of all this, floating can entail huge costs. It could be the catalyst for a shrinking financial system, as residents move their assets out of the domestic currency. A recent study by the Inter-American Development Bank suggests that Latin American countries with floating currencies end up with financial systems that are 15 to 30 percent smaller than they otherwise would have been. One reason is that letting the exchange rate appreciate in good times and depreciate in bad times reduces the incentive of residents to hold their assets in the domestic currency because it does not help diversify the income risk they already bear. In good times, when incomes are high and people are in a position to save, the value of their previously accumulated savings goes up through currency appreciation. In bad times, when income is low and people might wish to dip into their savings, they find their assets are worth increasingly less because of currency depreciation. Hence, residents of these emerging-market countries will want to hedge their savings by moving them out of the domestic currency. It will become apparent in coming years if this is also true of savers in Asian countries that have recently chosen floating rates.

Floating entails a second significant cost: Depositors demand a higher return to compensate for the higher instability in the value of their assets, thereby producing a much higher level of average real interest rates. In the 1990s, Latin American floater countries have averaged 9 percent real interest rates compared with 5 percent for countries with fixed exchange rates.

Finally, floating regimes tend to produce more wage indexation (salaries that are adjusted for inflation). When workers are asked to negotiate labor contracts in an unstable currency, they ask for protection from fluctuations. As wages become indexed, devaluations tend to have high inflationary effects because higher import prices lead to higher wages and thus to a wage-price spiral. For this reason, devaluations end up having limited effects on competitiveness. Knowing this, central banks try not to let the exchange rate move much and therefore have to rely on interest rates instead, which makes these same interest rates volatile.

Thus, the real life experience of Latin America shows that floating rates can generate quite unsavory results. What about the idea that floating reduces moral hazard because it forces investors to bear the real risks of moving in and out of emerging markets? Floating regimes might help increase stability by making some capital shy away from emerging markets, but they will also cause domestic savings to flee, leaving countries with fewer resources to finance growth. In addition, highly volatile domestic interest rates will make banking riskier and will conspire against the development of long-term markets. New Asian floaters may find it impossible to return to the rates of growth they were able to achieve over the last two decades. Finally, a system of floating rates does not solve the problem of original sin, which means emerging-market countries will remain crisis-prone.

An alternative to floating, strongly implied by the theory of original sin, would be for emerging markets to abandon national currencies altogether in favor of an international currency such as the dollar or a supranational currency such as the euro. This decision would expand the menu of financial options open to emerging-market governments and firms, and in doing so, would increase overall financial stability.

Surmountable Obstacles

Original sin suggests that promising countries with weak national currencies will become financially fragile, no matter how they manage their exchange rates. Abandoning the weak national currency in favor of a stronger international or supranational currency would eliminate the currency and maturity mismatches, because debts would be denominated in the same unit as a company's cash flow. It would also these countries to borrow longer-term. In spite of its checkered political history, for example, dollarized Panama has the largest domestic credit market in Latin America. It also is the only Latin country to offer 30-year fixed rate mortgages. (No wonder the Mexican business community wants to dollarize after only four years experience with a floating currency.)

In a financial sense, a world of international or supranational currencies would be more stable and safer for capital mobility. Long-term interest rates would decline and become less volatile, as we have seen in Europe, where interest rates have gone down in Ireland, Italy, Portugal, and Spain, making it easier to cut budget deficits and promote growth. This scenario seems almost too good to be true, and of course, there are several hitches.

First is the issue of seignorage. Because currency is worth more than its printing costs, printing money generates revenue for whoever owns the printing machine. Called seignorage, this income usually accrues to national governments. Under current conditions, any government giving up its currency would forgo this revenue. How big an obstacle is this? Yearly, seignorage in most countries currently accounts for perhaps .5 percent of the gross domestic product; this is not a huge amount and the benefits of adopting a supra-national currency may well exceed the costs. There is also the possibility that in the interest of maintaining the overall system, enlightened "owners" of international or supranational currencies (such as the United States and Europe) may be willing to share their seignorage with countries that adopt their currencies. The second apparent obstacle involves a nation's ability to act as a lender of last resort. Banking systems require a mechanism to guarantee their ability to cope with sudden withdrawals of deposits, since depositors may otherwise end up pulling their money for fear that others may do so before them. This is the reason that central banks usually act as lenders of last resort in domestic banking systems, giving loans against good collateral to commercial banks. Abandoning the national currency means eliminating the central bank's ability to print money, which is currently how last-resort lending is usually provided. An alternative therefore needs to be found that does not involve transferring the risks to other countries.The solution to this problem requires some sort of collateral. If a country could put credible collateral on the table, it could even contract out the lender-of-last-resort function to the international private market.

With good collateral, it would likely be feasible for countries to negotiate credit lines for use in times of trouble, as Argentina has recently done. The collateral could come from several sources, but obviously a sharing of the seignorage would provide a good starting point. If a country such as Argentina were to put up the equivalent of its seignorage as collateral—by being allowed to exchange its current stock of peso bills for U.S. dollars at no cost—it could then dedicate its international reserves not to backing up its currency, but to assuring the liquidity of its banking system. The lender-of-last-resort issue would thus seem manageable.

The issue of asymmetric shocks appears more difficult. Adopting an international or supranational currency would not be a panacea: Countries would still undergo shocks, and they would be unable to devalue or lower interest rates in response. Yet, they might not be any worse off than at present. We have already seen that emerging-market countries in Latin America with floating regimes seem powerless to use monetary and exchange rate policy to cushion and absorb shocks. Moreover, many of the shocks that emerging markets suffer are a consequence of the financial fragility that comes from having a domestic currency. In a world of fewer national currencies, this financial turbulence would presumably be smaller.

In addition, deeper and longer-term financial markets would allow companies and firms to cope with other kinds of shocks. On balance, the system may in fact tend to be more stabilizing than at present, and of course, more could still be done to tame the effects of potential shocks on emerging-market economies. In a system of fewer currencies, factors such as fiscal policy, the hedging of commodity prices, and labor-market flexibility would likely play a larger policy role than they do today.

Finally, there is the issue of sovereignty and governance. Who would set policy in whatever central banks that remain? This issue is probably less important than it might appear. The past 20 years have been marked by the increasing independence of monetary authorities and a narrowing of the objectives of these institutions to the achievement of price stability. The members of the board of the European Central

Bank (ecb) are not there to represent their countries of origin. In spite of Germany's leading role in the ecb (the bank is located in Frankfurt), German finance minister Oskar Lafontaine could not get the ecb to lower interest rates to help combat high German unemployment. What consideration would the finance minister of Portugal or Luxembourg expect to receive? Ultimately, questions of the monetary authorities' autonomy and accountability are much more important than the issue of their national origins.

Fewer Currencies: Just a Matter of Time

National currencies based on fiat money have a limited history. Through most of history, the world has had very few currencies, most of them tied to gold or silver. It has only been in the past few decades that we have seen the emergence of the notion of one country, one currency. Even the framers of the Bretton Woods system conceived of a system tied to the dollar. A world of over 100 freely floating currencies has never existed and is unlikely to be stable or compatible with globalization. Europe has opted out of such a regime, instead going for a supranational currency.

Emerging markets will follow a similar course, adopting currencies in which they can borrow abroad and long-term. This scenario also implies that the emerging currency areas will want to create their own international monetary institutions and do away with the imf. If the Czechs, Hungarians, and Poles opt for the euro, neither they nor the ecb will want the Japanese and Americans involved in their monetary issues. Similarly, if Mexico dollarizes, the United States will be loathe to negotiate related issues with the Japanese and Europeans. The imf was created for a dollar-centered world: It is unlikely to survive in its present form in a world of regional currencies.

One final problem with abandoning national currencies is the symbolism involved. National currencies, like flagship airlines, are emblems of national identity.

But as more and more airline customers are foreigners, the national character of airlines is increasingly viewed as a liability. We are now seeing the emergence of a few huge global alliances in the industry. Similarly, telecommunications and energy "flagship" companies are downplaying their national roots and instead positioning themselves as global players. Should the U.S. Bureau of Engraving and Printing take the hint? Could something other than drawings of founding fathers and past presidents eventually find its way onto U.S. dollar bills? How about great artists or scientists, with their more universal appeal? And by the way, what about a woman?

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